CHAPTER I

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1.1 INTRODUCTION

The Indian banking system is based upon the British banking system which is largely branch banking. Commercial banks in India started during the later half of the 19th Century. The strengthening of the banking system took place after the establishment of the Reserve Bank of India in 1935 and it was empowered to regulate.

In 1955, the State Bank of India Act was passed. In 1959 the State Bank of India (Subsidiary Banks) Act was passed by which the public sector banking was further extended with eight banks.

In 1969, fourteen major Indian commercial banks were nationalised and in 1980 six more banks were added on to constitute the public sector banks. There are thus nineteen banks in the public sector, excluding SBI and its seven associate banks. Commercial banks in India are primarily divided into scheduled banks and Non-scheduled banks.

Scheduled Banks

The second schedule of the RBI Act contains a list of banks which are described as "Scheduled banks". The scheduled banks enjoy several privileges. The affairs of scheduled banks are closely watched and largely controlled by the RBI in order to safeguard the general health of the banking industry as a whole.

Public Sector Banks

The All India Rural Credit Survey Committee recommended the creation of one strong integrated, state sponsored, state partnered, commercial
banking institution with effective branches spread over the whole country. In pursuance of its recommendations, the Imperial Bank was nationalised and renamed as a State Bank of India from July 1, 1955. Nationalisation of the Imperial Bank of India heralded the entry of public sector into commercial banking. To further strengthen the public sector banking structure, eight state associated banks were taken over by the State Bank of India as its subsidiaries with the passing of the State Bank of India (Subsidiary Banks) Act. 1959.

In order to bring about far reaching changes in the concept and working of banks in India, the scheme of social control over commercial banks was introduced in 1967. The basic objective of the social control policy was to ensure, in the immediate future an equitable and purposeful distribution of credit within the resources available keeping in view of the developmental needs. Nevertheless, the Government felt that the social control experiment was basically inadequate to achieve the social goals and objectives. On July 19, 1969, the Government nationalised 14 major scheduled commercial banks each with a deposit of Rs. 50 crore and above. The sole objective of bank nationalisation in 1969 was to rectify the socio-economic malaise that resulted from the localised, urban biased and profit oriented development of the privately owned banking sector over the years. The continuation of wide disparities in the development pattern of states, regions, and sectors, the widening poverty gap, growing unemployment and the enlarging economic disparities were to a large extent traceable to the pattern of banking facilities that existed so far. It was felt that banks as an important financial intermediary and with stupendous investment capacity should act in such a way that they could make a significant impact on reducing the disparities by increasing employment and on mitigating the problem of poverty. On April 15, 1980 the
Government nationalised six more scheduled commercial banks each with a deposit of Rs. 200 crore or above. Thus, from 1980 onwards Government came to own 28 banks including the State Bank of India and its seven subsidiaries. Today, the public sector banks including regional rural banks account for 91 per cent of the deposits and advances and about 87 per cent of the branches of all commercial banks.

**Private Sector Banks**

A new history of Indian banking began submission of the Report of the Committee on the Financial System headed by Mr. M. Narasimham. After the nationalisation of major commercial banks, though some private sector banks continued to exist, starting new private sector banks was not possible. The major chunk of Indian banking being handled by the public sector, there was virtually no competition in the banking sector and this was found to be one of the factors responsible for the growing inefficiency in Indian banking. The Committee on Financial System, which was very much concerned with efficiency and productivity of Indian banking, recommended that the entry of new private sector banks should be permitted. It said, "The Committee recommends that freedom of entry into the financial system should be liberalised and the Reserve Bank should now permit the establishment of new banks in the private sector, provided they conform to the minimum start up capital and other requirements and the set of prudential norms with regard to accounting, provisioning and other aspects of operations." This recommendation paved the way for the establishment of new private sector banks. The old private sector banks in India are 21 in number. In all, 9 private sector banks were established and after the merger of Times Bank Ltd. with HDFC Bank there are currently 8 new private sector banks. New private sector
banks have been in existence for a very short period. Nevertheless, it is worthwhile examining how they have grown and whether their performance is better than that of public sector banks and if so what factors have contributed to this situation.

1.2 STATEMENT OF THE PROBLEM

The Indian bank management, today, is facing a two-faced challenge to improve their profitability on the one hand and to serve the public in new ways with greater efficiency and effectiveness on the other. In the noble task of fulfilling the socio-economic responsibilities commercial volatility of the banking should not be ignored.

Out of total expenses, an establishment expense is a major expense which is met by scheduled commercial bank particularly public sector bank due to more number of employees. This expense should be met and this put an impact on efficiency of the commercial banks.

The objectives of Indian Commercial Banks have been very important to assess their profitability performance. Due to the approach of policy makers, the policy towards profitability has changed and low profits have become a fact. There is a growing evidence about the declining profitability of the banking system. Therefore it is a high time to analyse the profitability position of scheduled commercial banks in India.

The branch performance has also been analysed as certain unviable branches are functioning in rural areas without much regular operation.
The level of Non-Performing Asset in banks has been found to be a serious aspect. It has to be controlled as this mounting Non-Performing Asset affects the profitability of the Scheduled Commercial Banks.

With the change in the social and economic objectives of Indian commercial banks, particularly of the scheduled commercial banks, it becomes extremely essential to assess their profitability performance in the wake of new banking philosophy.

In view of the importance of improving the profitability performance of the banking sector in recent years, all scheduled commercial banks in India have been taken by the researcher by dividing it into three groups namely SBI Group, nationalised bank group and private group.

In this regard the researcher has to probe further to find solutions for the following questions.

1. How far the efficiency, profitability and growth are interrelated?
2. What are the factors to be concentrated by the bankers to improve its existing financial performance?

1.3 REVIEW OF LITERATURE

A number of research studies have been conducted in India on various aspects of banking sector. Some worthwhile studies relating to the present topic are being reviewed here.

Varde and Singh1 (1973) of National Institute of Bank Management conducted a number of studies on the profitability of commercial banks and has
recently complied them in a short book titled "Profitability of Commercial Banks". The book covers different issues related to profitability of banks like profit management in banks, productivity in banks, profit planning in banks, monitoring profitability of bank branches, measuring cost of funds for banks, matching revenues and costs of commercial banks and operating cost of rural retail banking.

**Luther Committee**\(^2\) (1976) appointed by Reserve Bank of India to study the productivity, efficiency and profitability of commercial banks. The committee analyzed the various issues related to the planning, budgeting and marketing in commercial banks, bank management information system, criteria for evaluation of bank performance, annual accounts of banks, trends in earnings and expenses of banks and profitability as well as pricing of banking services. The major recommendations of the committee were: (i) The capital base of banks need to be improved. For this, banks should transfer at least 40 per cent of the disclosed profits to reserves, free of taxation. (ii) The interest on additional cash reserves in excess of the minimum 3 per cent should be related to cost of funds for banks. (iii) In the light of social obligations cast on the banks, tax laws need to be revised. (iv) To estimate the cost of various services and profitability of different activities, the Reserve Bank of India in collaboration with commercial banks should organize regular and systematic surveys. (v) To improve productivity, efficiency and profitability of banks, a systematic, prompt and regular flow of information and its analysis is essential for banks to contemplate timely corrective actions. (vi) There should be uniform system of audit for all categories of banks, on the lines of the one prevailing in the State Bank of India. (vii) Simplification of systems and procedures in banks is necessary to bring economy in expenses and to provide better customer services.
Angadi (1983) measured the efficiency in terms of responsiveness of operating cost which influences the profitability of the banking industry. He pointed out some important yardstick like operating cost responsiveness, administered prices/interest rates to output of operational efficiency of banks.

Joshi (1986) has analysed the trend of gross and net profits of all scheduled commercial banks. He largely holds lower capacity for fund management of the bank due to SLR, CRR and priority sector lending. He found out that there had been lowering yield rate and rising cost rate year by year which contributed a lot to the declining trend in profitability. He viewed that declining demand from the corporate sector for bank funds had serious implications for bank profitability.

The focal point of the study made by Vashisht (1987) was to critically evaluate the trends and progress of commercial banks in India during the period 1971 to 1983. The ratio analysis is used to evaluate the performance of commercial banks with respect to different indicators. However, overall performance of each bank is assessed with the help of Relative Growth Indices. The analysis revealed that commercial banks did very well with respect to branch expansions, deposit mobilisation, credit disbursement and priority sector advances. However, it was observed that banks are plagued with the problem of declining profitability. Indian Overseas Bank secured the top position and Dena Bank was placed at the bottom with respect to overall performance indices.

Chopra (1987) in her empirical work "Managing Profits. Profitability and Productivity in Public Sector Banking" studied the emerging trends in the
profits and profitability of some selected public sector banks at micro level. She highlighted the need for the introduction of management essentials for better management of profits and profitability of public sector banks and recommended proper management of both costs as well as earnings.

Karunagaran and Benjamin\textsuperscript{7} (1989) analysed the performance of commercial banks in Tamil Nadu during 1969-1986. The analysis was carried out with the help of some simple indicators like population coverage by banks, distribution of their branches, deposits and advances in different population groups etc. The progress of commercial banks in the State (Tamil Nadu) was also compared with that in the country as a whole. The analysis pointed out that by and large. the banking industry in Tamil Nadu was not in a good state of health.

Pandey\textsuperscript{8} (1989) made a retrospection of the banking trends and analysed the prospects of growth in the business of commercial banks in view of the multi-dimensional problems, which they are facing in the fast changing economic scenario. It was observed that though the banks have been doing considerably well, in future they would have to act as a supreme financial market and should invest in non-traditional sectors to maintain their viability in view of the emerging challenges.

Amandeep\textsuperscript{9} (1990) in her work evaluated the profits and profitability of nationalised banks. The study analysed the factors that influence the profitability of banks and suggested that in order to improve the banks' profitability, the banks need to focus attention on the management of spread, burden, establishment expenses, income and deposit composition. The study
observed that priority sector lending and rural banking do not have an adverse effect on the banks' profitability to a significant extent. Hence, advances to the priority sector and opening of rural branches may be extended in the larger interests of the society.

Chakrabarty\textsuperscript{10} (1990) studied the impact of credit policy on profitability and viability of Indian banking system. The analysis indicated that banks have become loss making units and whatever profit is recorded is at the cost of long-term viability of the banking system. It is suggested that the only alternative left is to make the necessary changes in the credit policy, in general, and interest rate structure in particular, which alone can improve the overall profitability of the banks.

The paper written by Padwal\textsuperscript{11} (1991) addresses itself to the Indian banking experiences during the decades of seventies and eighties and emerging scenario in the nineties. It is observed, that high cost of branch expansion and growing percentage of credit portfolio to generally low yielding assets, increasing cost of personnel administration and establishment have adversely affected banks' profitability. It was noticed that though deregulation in banking sector is expected to help widen credit markets, to reduce the segmentation in them, enhance saving mobilisation and stimulate competition, yet the past trends do not show this happening in the country. The researcher is of the view that Indian banking industry may need to undergo major changes before it becomes ready to face full liberalisation of the financial sector.

Panda and Lall\textsuperscript{12} (1991-92) in their paper attempted to develop certain internal management techniques for improving the profitability of the Indian
Banking system. The authors have identified productivity, deployment of funds, quality of advances, information system and organisational set up and branch expansion policy as the most important factors influencing the profitability.

Subrahmanyam\textsuperscript{13} (1991) observed that the liberalisation measures of the late 80's have not led to promote the efficiency and stability in the banking sector. In order to have better performance of banking sector, it is important that further doses of liberalisation should be introduced in this sector. The problems relating to operating expenses and interest rates structure are also reviewed in detail. It is suggested that the main focus of reforms should be the restoration of financial health of the banks but not privatisation as such.

Ramachandran\textsuperscript{14} (1992) observed that profitability of banks' is on the decline. In his paper, he traced out in brief the causes for declining profitability and suggests possible measures for arresting this trend. The main causes among others traced by the author are (a) emphasis on social goal (b) increase in establishment cost (c) blocking fund in sick unit (d) compliance to statutory requirement (e) rural branch expansion (f) leakage: in income (g) poor cash management and others.

Singh\textsuperscript{15} (1993) in his work on productivity of Indian banks has divided 22 public sector banks into two groups - SBI group and 14 nationalised banks. He has used seventeen indicators to analyse productivity trends of the Indian banking sector and studied the inter group differentials of SBI group and nationalised banks over 1969 to 1985.
Swami and Sooraj\textsuperscript{16} (1993) made a comparison between the level of efficiency in 28 public sector banks during the period 1971 to 1973, and 1987 to 1989. Compound growth rates were calculated to analyse the increase in different banking indicators during this period. Taxonomic technique was used for driving a single measure of performance based on several indicators of banks' business activities. Most of the banks registered huge difference with respect to their overall performance as compared to the ideal one.

R. Murugadoss\textsuperscript{17} (1993) in his study has focused that the emergence of large size of NPAs as a result of application of the prudential accounting norms prescribed by the RBI is a matter of great concern for the entire banking system in the country. Evident outcome of the application of new norms in Indian banking is the turning out of many banks into red in 1992-1993. This being the scenario, the banks have no option but to go for slashing down the level of NPAs was footing barriers in a planned and systematic manner.

Amandeep\textsuperscript{18} (1993) in her study on profitability of commercial banks' has attempted to examine the trends in profits and profitability or twenty nationalised commercial banks with the help of trend analysis, ratio analysis and concentration indices of the selected parameters. The study focusses at identifying the various factors and empirical testing as to which of the identified factors have significantly contributed towards banks profitability in either direction. Using the multi-variant analysis, she concluded that it is the efficient management of the burden (as against the widely believed 'spread' element) which plays a major role in determining the profitability of commercial banks. In spite of lack of control of few determinants of burden, it is inferred that bank' profitability can significantly be enhanced by judicious management of the burden.
Chidambaram and Alamelu\textsuperscript{19} (1994) studied the problem of declining profit margin in Indian public sector banks as compared to their private sector counterparts. It was observed that in spite of similar social obligations, almost all the private sector banks have been registering both high profits and high rate of growth, with respect to deposits, advances and reserves as compared to public sector banks. The regional orientation, better customer service, proper monitoring of advances and appropriate marketing strategies are the secrets behind the success of private sector banks.

Debnath\textsuperscript{20} (1994) critically analysed the approach of commercial banks. in managing the non-performance assets. It was observed that the credit management efforts of the banks so far have proved ineffective in checking the problem of growing non-performance assets. An altogether new managerial approach was suggested for managing credit asset.

Satyanarayana\textsuperscript{21} (1995), after ascertaining the exact position of the banks in the post reforms period, analysed the strategies the banks should adopt to improve their capital base. It was emphasised that after reforms, a new basis of classifying the public sector banks, depending on profitability level, has emerged. The study revealed that in 1994 out of total 27 public sector banks, fifteen belonged to 'A' category. (those banks, which have significant income to earn net profits after making necessary provisions and contingencies). Seven banks were operating in 'B' category. (those banks, which after operating profits have not sufficient funds to provide for the provision, thereby incurring net losses). And the remaining were placed in the 'C' category (those banks, which were unable to earn significant income to enjoy sufficient operating profits). Apart from studying the profitability of above-mentioned groups of
banks, capital adequacy position and other balance sheet trends were also discussed. Further, some short term and long term strategies for enhancing the profitability level were suggested.

Srinivasan (1995) studied the experience of public sector banks in priority sector lending during the period 1969 to 1989. The study highlighted the achievements of the banks in securing the desired allocational pattern of credit in different sectors and sub-sectors. He derived home the point that the burden of priority sector lending is borne mainly by the public sector banks and other institutional agencies. It was observed that the regional rural banks and the co-operatives have not played their due role owing to certain structural deficiencies in their working. The study revealed that there was a fall in spatial and sectoral imbalances in banking operations over a period of time.

A study sponsored by the World Bank (1995) and done by a private consultancy organisation analysed the problem of poor profitability of commercial banks and regional rural banks in India during early 1990's. The study revealed that on account of comparatively small operating income on the one hand, and high operating expenses on the other, the commercial banks have been incurring losses. It was suggested that for commercial banks minimum lending rate should be between 16.69 and 17.6 per cent. It was observed further, that the commercial banks can improve their financial health by reducing their operating cost as well as through decrease in loan loss provisions. Further, the study suggested that there should be a complete deregulation of interest rates in rural loans persuaded by different institutions The rural operations of the commercial banks can be self-sustaining if loans appraisal and their repayment follow-up systems are tightened.
Das (1997) in his study reviewed the overall efficiency (technical, allocation and scale) of public sector banks for the period 1990-96. The study found a decline in overall efficiency, due to fall in technical efficiency, which was not offset by an improvement in allocative efficiency. However, it pointed out that the deterioration in technical efficiency was mainly on account of few nationalised banks.

Sarkar and Das (1997) highlighted the performance of public, private and foreign banks by using measures of profitability, productivity and financial management for the year 1994-95. They found public sector banks competing poorly with the other two categories. However, they caution that no firm inference can be derived from a comparison done for a single year.

The focus of the study done by Satish and Gopalakrishna (1997) was to see whether non-viability of banking institutions is structurally in-built or not. For that they selected four districts in Maharashtra and evaluated the profitability position of the commercial banks. The analysis revealed that there were wide inter-branch variations in interest income and interest expenses. Interest incomes and interest expenses were influenced respectively by the proportion of non-performing assets and deposit mix. In addition to it, transfer-pricing policies, adopted by the head office, were also responsible for inter-branch variations in them. It was concluded that there is nothing intrinsically non-viable about rural banking operations. It was argued that quantitative expansion and qualitative improvements in their business would lead to economies of scale in banking operations, thereby resulting in lower per unit cost of management and, consequently, higher profitability.
Kohli\textsuperscript{27} (1997) reviewed both the theory and empirical evidence on directed credit programmes to small-scale enterprises and analysed it in the Indian context. After making a comparison between implementation of such programme in East Asia and India, some policy conclusions for the Indian financial sector were suggested. The cost and benefits of priority sector lending in India was calculated and was argued that credit policy in India needs to be re-appraised and geared towards more specific objectives. These objectives should be defined locally so that on the basis of that the banks will be able to decide as to which firm or industry can be financed. In addition to it, the researcher suggested for an introduction of the system of periodic review of targeted firms and industries, designing a sharply focussed credit policy with incentives structured to reduce moral hazard and ensure good performance, and streamlining of the monitoring and supervisory functions of the banks.

Satyanarayana\textsuperscript{28} (1997) has discussed the feasible non-performing asset (NPA) levels of banks for Capital Account Convertibility. It is observed that public sector banks in India may not be able to bring down their gross non-performance assets to 5 per cent as prescribed by Tarapore Committee on Capital Account Convertibility. It is argued that the prescribed level of 5 per cent of 'non-performance assets defies the market logic on the one hand and ignores the limitations of working in very slow and very ineffective legal social and political climate of recovery on the other. It is observed, that the strong banks exhibit confidence, moving towards internationally competitive levels of capital adequacy, profitability and adequate coverage of non-performance assets, whereas the position of weak banks is precarious.
Mujumdar\textsuperscript{29} (1998) in his article emphasised the importance of priority sector lending for the growth of the economy as a whole. He was of the view that public sector banks must support these sectors irrespective of the fact that whether there are credit targets or not. In view of the Ninth Plan priorities, it is important that credit policy should be so framed that agriculture and other priority sectors must get their due share in the reform period.

Leon, Janina Virginia\textsuperscript{30} (1997) studied the cost frontier analysis of efficiency of Peruvian Municipal Banks. The twin goals of this dissertation study are to compare two frontier techniques to measure efficiency, and to evaluate their contribution in policy application, in relation to the case of Peruvian Municipal Banks (PMBs). For comparative purposes, an analysis of consistency is made using alternative cost frontier approaches for the same set of firms. Adopting the frontier analysis of efficiency and assuming minimum cost as a basic behavioural goal of PMBs, cost efficiency is defined by an institution's minimization of costs. The study focuses its attention to increase the profit of PMBs to a maximum extent with the help of minimization of cost.

Bhatia and Verma\textsuperscript{31} (1998) made an attempt to determine empirically the factors influencing profitability of public sector banks in India by making use of the technique of multiple regression analysis. Net profit as percentage of working funds has been used to measure the bank profitability during 1971 to 1995. The analysis revealed that priority sector advances: fixed/current deposit ratio and establishment expenses affected the profitability of public sector banks negatively. Net spread, which to a great extent depends on the management acumenship of the bank staff, influenced the profitability of banks positively and significantly. High credit-deposit ratio was also observed to be:
influencing profitability positively. However, its impact was found to be statistically non-significant.

Deb\(^\text{12}\) (1998) critically studied the growth of banking system in India covering the period from 1966 to 1987. The analysis revealed that the structure of the banking system changed considerably over the years. It was further pointed out that the quantitative growth of the public sector banks was no doubt significant in some of the areas, but qualitative improvement, by and large lacked in desired standard. In spite of substantial increase in deposit mobilisation, their share in national income continued to be very low. It was concluded that the public sector banks were neither always guided by the consideration of returns nor were they very much concerned with development strategies.

A study was conducted by Ganesan, P\(^\text{13}\) (1998) titled “Priority Sector Advances vis-à-vis Profits and Profitability of Public Sector Banks in India (1969-1993)”. In his study, he focused his main attention to analyse the following aspects: i) economies of priority and non-priority sector transactions with reference to spread, burden and surplus: ii) the use of efficiency, liquidity and profitability ratios to assess the operational efficiency; iii) determinants of profitability to derive a profit function model; and iv) the economies of scale regarding cost, production and profit functions. Finally, the study pinpoints certain ideas for the improvement of profitability and the technical change to be made to recover the overdues of priority sector advances.

S.P. Talwar\(^\text{14}\) (1999) at the conference of chairman of private sector banks in India, has addressed that in many cases section 20 of the Banking
Regulation Act 1948 is violated, which prohibits loans to directors or to any firm or company in which directors are interested. He has pointed out that as it has not been adhered to and violated in spirit, it ultimately resulted in the loan facilities turning as NPAs. Such instances which have come to light during the course of inspections and through off-site reporting by banks are viewed seriously by the central bank.

K.J. Tari (1999) in his paper entitled NPA management in SBI some issues, has focused that Indian Industry for the last two years has been reeling under a complete loss of confidence due to demand recession coupled with oversupply position in many commodities. This situation has led to weakening of prices and adversely affected the repaying capacities of many industries. Thus statistics reveal that recoveries and upgradation made in NPA accounts are set off due to additions of New NPA.

The focus of the study made by Das (1999) was to compare the inter-bank performance of the public sector banks for three years (1992, 1995 and 1998) in the post-reform period. He found a certain convergence-taking place in the performance of the banks during the period under study. It was observed that whereas an increase in emphasis on non-interest income is a welcome change but the banks behaviour to opt for risk free investments over risky loans may have serious effects on the economy.

Rajaraman (1999) explained inter-bank variations in net non-performing assets (NPA) for the year 1996-97. The study was performed by a specification that included intercept dummies by ownership category, bank-specific prudential and efficiency indicators, and region of operation as
measured by percentage branches in each of a set of state clusters. The analysis revealed that the foreign banks of Asian and West-Asian origin performed no better than domestic private sector banks in terms of NPAs. The findings show that the banks' specific characteristics, such as ownership or adherence to prudential norms, do not suffice to explain inter-bank variations in NPAs. It was concluded that the sustainable reforms in the financial sector and improvement in the performing efficiency of the domestic banks are very essential.

A study by **Srinivasan, Aruna** (1998) on "A Multi-Product Cost Study of Rural Bank Branches in Bangladesh" has adopted two alternative approaches to estimate costs: the production and intermediation approaches which focus on operating efficiency and economic viability, respectively. The effect of product mix on costs and the relationship between loan recovery and bank viability are also studied. Data from a sample of rural bank branches of four nationalized commercial banks and the agricultural development bank for a period of two years (1993 and 1994) were used in the analysis. The researcher finally pinpoints to succeed in its policy of rural lending without committing scarce resources to subsidizing rural bank branches. It must simultaneously deal with two problems, namely, the minimum spread required for the banks to cover intermediation costs and how to improve the conditions for better loan recovery.

**Lacewell, Stephen Kent** (1999) examined the association between bank characteristics, efficiency and financial performance. According to him, the area of performance measurement can be divided into two rather large streams of research: bank efficiency measures and accounting-based financial
ratios. This study merges these two seemingly separate areas to determine when and how the two should be used in combination. This study consists of multiple stages. One of the important analyses in his research work is the estimation of cost and alternative profit efficiency scores using a national model and a size-specific model.

**Nettime and Kuruba (2000)** observed that the pace of reforms in banking sector in India is definitely encouraging and giving positive signals of structural changes in the financial sector. However, it was opined that the reforms would be successful only if the level of NPAs is reduced. In order to tackle the problem of NPAs there is need for legal reforms. It is the attitude and efficiency of the banking authorities, which have to go a long way in making the banking reforms operationally and functionally effective.

The **RBI (2000)** studied that how deregulation has affected the banks' performance. The RBI's study covered all categories of the banks. It was observed that there has been a decline in spreads and a tendency towards their convergence across all the bank-groups except foreign banks. Intermediation costs as percentage of total assets was also found to have declined especially for the public sector banks and new private sector banks, largely due to a decline in their wage cost. Capital adequacy and asset quality have both improved over the period 1995-1996 to 1999-2000. Median profit per employee of the public sector banks witnessed a significant rise between 1996-1997 to 1999-2000. Further, it was found that non-interest income to working funds also rose modestly for the median public sector bank. The cost to income ratio declined both in the SBI group and the nationalised banks.
Ahmad, Taha Khaled (2000) made a study on the efficiency of the banking system in Jordan. This study is an attempt to examine the efficiency of the banking system in Jordan during the period of 1990 to 1996. The study presents a comparative analysis of the frontier cost efficiency methodologies by applying econometric and mathematical programming techniques. The study also analyzes the profit efficiency of the Jordanian banks during the same period of time by estimating a non-standard profit function. The findings of the second stage regression indicated that banks with fewer employees per total assets, lower ratio of branch per total deposits, higher asset and higher salaries to total assets ratios were most cost efficient banks. The profit efficiency was found to be positive correlation with growth in bank total assets, age and size of the bank. However, the profit efficiency was found to be negative correlation with the ratios of branch to total deposits, number of employees and salaries to total assets, and risks.

Kannan (2001) made an attempt to identify the factors influencing spreads of Scheduled Commercial Banks in India. The relevant data for the period 1995-1996 to 1999-2000 was collected from the 27 public sector banks, 31 private sector and 28 foreign banks. For the purpose of analysis, time series pooled data estimation procedure was used. Pooled data models presuppose the fact that the differences across units can be captured in differences in constant term as in fixed effect models. The Generalised Least Square approach was also used for carrying the analysis. The study revealed that size (bank size) does not necessarily imply higher spreads. Secondly, higher non-interest income as a share of total assets (fee) enables banks to tolerate lower spreads. With regard to regulatory requirement variables, it was found that capital plays an important role in affecting spreads of the public sector banks. Non-
performing assets were found to be uniformly relevant across all the bank groups in influencing spreads.

Misra and Mishra (2001) discussed the different problems, achievements and prospects of development of commercial banking in India. It was observed that under banking sector reforms the commercial banks have progressed significantly in several directions. However, it was suggested that full autonomy should not be granted to the banks on account of different inherent deficiencies in the market system because ultimately the State is responsible to the general public for the wrongs committed by banks.

Nayak (2001) made an attempt to compare liquidity, productivity and profitability of foreign and domestic banks in India during 1985-1986 to 1996-1997. The study is based on bank-wise secondary data on number of variables like employees, branches, total assets, interest paid and expended, total deposits and advances, profits and expenses. The results revealed that productivity in terms of labour, branches and profitability was higher in foreign banks than the domestic banks. Foreign banks are least involved in socio-economic policies of the government, on account of which they registered higher profits.

Singh (2001) made an attempt to assess the impact of the reforms on the operational performance and efficiency of the commercial banks in India. The ratio analysis has been used as a major tool for assessing the performance of the selected commercial banks. The study revealed that total income as a percentage of working funds and or total assets, and spread as a percentage of total income/working funds/total advances/total deposits have improved in
the post-reform period against the pre-reform period in most of the banks. Total income interest earned, other income, spread, total expenses, interest expended, operating expenses and establishment expenses are comparatively more consistent in the post-reform period. The hypothesis that the profitability position has improved in post-reform period may be accepted to some extent. It was observed that in the public sector banks the size of NPAs has also reduced to some extent and quality of service has improved in the post-reform period. The priority sector lending has registered a decline in the deregulation era.

Subramani and Raghav (2001) analysed and compared efficiency in the six public sector banks, four private sector and three foreign banks for the year 1996-97. Operational efficiency is calculated in terms of total business and salary expenditure per employee. The analysis revealed that higher per employee salary level need not result in poor efficiency and business. Per employee efficiency co-efficient were also calculated. Among the public sector banks, Bank of Broda registered the highest efficiency and operating profit per employee. Among the private sector banks Indus Bank followed by City Bank registered the highest and second highest operating profit per employee respectively. However, amongst the nationalised banks there existed wide variations of efficiency.

Bhide, Prasad and Ghosh (2002) while evaluating the banking sector reforms in India observed that there has been a commendable improvement in the profitability of the public sector banking system, measured in terms of operating profits and net profits. It was pointed out that the inter-mediation process has also improved, as is the evident from the ratio of net-interest income to total assets of public sector banks. The profile of assets portfolio and
the extent of the net non-performing loans as percentages to total assets also exhibited improvement during the period 1992-1993 to 1999-2000. According to the study externality of the reforms process has been the building up of the institutional architecture in terms of market and creation of enabling environment through technological and legal infrastructure and improving the managerial competency. They further identified the different shortcomings of the banking system and pointed out that faulty debt recovery process, inefficient legal system and inadequate risk management techniques etc. are the major weaknesses. It was observed that the reforms could not be entirely painless.

**Chaudhuri (2002)** examined some important relevant issues relating to growth and profitability in the public sector banks for the year 1995-2001. It is opined that the public sector banks are facing triple jeopardy. First they are losing market share, second their profitability is being seriously squeezed and lastly their balance sheets are not strong and their sovereign support, which had buttressed them so far, is becoming open to question. The reason for this less than enviable condition of the public sector banks are many, but a principal operative factor derives from the nature of their ownership and what translates in terms of goal and priorities. However, it was concluded that the public sector banks in India are neither very strong nor very weak. But they do not have any further capacity to bear the burden of pursuing government policies.

**Mathur** (2002) in his paper raised different issues, which arise in the context to privatisation of the commercial banks in India. The re-capitalisation and budget burden argument was examined. Further, issues relating to competition, efficiency and ownership were also analysed. After giving an over
view of financial sector reforms, their impact on the performance of the public sector banks was also evaluated. It was concluded that the case for privatisation of the public sector banks in India is not strong enough. The researcher warns that the private sector banking would have a larger probability of crisis if the supporting legal and regulatory framework were not sound enough to insulate the system from the adversaries of extraneous pressures.

The purpose of the article written by Das (2002) was to understand the interrelationships between risk-taking and productivity in the public sector banks in India. The study covers the time period from 1995-96 to 2000-2001. The analysis revealed that capital adequacy has a negative and significant effect on asset quality when the public sector banks were considered in totality. Secondly, it is observed that non-performing assets play a major role in influencing the capital levels of the small as well as big banks. Thirdly, it is observed that capital and non-performing assets remain crucial factors in influencing productivity. Finally, regulatory pressure, both with regard to capital and non-performing assets play a significant role in influencing the capital adequacy and asset quality of the public sector banks.

D'Souza (2002) in his study evaluated the performance of public sector, and foreign banks during the period 1991 to 1999-2000. The efficiency of the banking system was measured in terms of spread working funds ratio and turnover / employees ratio. With reference to the spread working funds ratio, the efficiency of the commercial banks as a whole declined in the post-reform period. The public sector banks have been responsible for this decline in efficiency, as the efficiency of the private and foreign banks has improved over the course of 1990’s. Though the turn over / employee ratio has risen in the
public sector banks, the turnover per employee in the private and foreign banks doubled relative to the ratio for public sector banks during this decade. However, the analysis revealed that the profitability of the public sector banks in late nineties improved relatively to that of private and foreign banks.

Ram Mohan (2002) in his paper documented and evaluated the performance of the public, private and foreign banks since deregulation in absolute and in relative terms, and attempted to understand the factors behind their improved performance. It was observed that the efficiency of the banking system as a whole measured by declining spreads has improved. The performance of public sector banks have improved both in absolute and relative terms. He alludes the Indian banking industry for its ability to keep its head above water log after deregulation. Further, he takes up the issues of trade-off between efficiency and stability in banking. It is observed that efficiency should not be at the cost of stability. He cautions that Indian experience so far suggests that government ownership might conduce to such trade off.

K. Kothai (2003) Non Performing Assets of Scheduled Commercial Banks in India an Analysis – in her paper she has analysed all the three groups (Public, Private and Commercial Banks). Public Sector Banks has recorded good achievement in terms of branch expansion deposit mobilization and deployment of credit and regarding non-performing assets the performance of the public sector banks are extremely good. The NPAs of this group has been showing decreasing trend during the study period. The study reveals that the reduction of NPA is mainly due to write off of bad debts and expansion of total advances over the year.
1.4 OBJECTIVES OF THE STUDY

The study has been undertaken with the following objectives

1. To present the determinants of efficiency, profitability and growth of commercial banks in India.

2. To examine the branch based and employee based efficiency of scheduled commercial banks in India.

3. To assess the financial parameters which affects the profitability of the scheduled commercial banks in India.

4. To analyse the trend and progress of scheduled commercial banks on selected variables.

5. To offer suitable suggestions for the better financial performance of scheduled commercial banks in India.

1.5 PERIOD OF THE STUDY

The study covers a period of ten financial years i.e., from 1995-96 to 2004–2005. The financial year starts from 1st day of April of a year and ends on 31st day of March the next year.

1.6 SCOPE OF THE STUDY

The present study aims at analysing the financial performance of Commercial Bank. Since Scheduled Commercial Banks represent majority of commercial banking activity in India, the study is confined to Scheduled Commercial Banks particularly with regard to public sector banks and private sector banks.
1.7 SAMPLE DESIGN

The performance of a bank can be measured by a number of indicators. Among these, efficiency, profitability and growth play an important role and the selection of banks are based on census method.

The data for the study has been collected mainly from the secondary source comparing various Books, Periodicals and Journals. Further for the purpose of analysis, detailed information were collected form various volume published by the Statistical Department of RBI, Mumbai RBI, Bulletins, Reports on Trend and Progress of Scheduled Commercial Banks in India, Reports on Currency and Finance etc..

1.8 CONCEPTS

i) Banking

Section 5 (b) defines banking as accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise. Section 49A of the Act prohibits any institution other than a banking company to accept deposit money from public withdrawable by cheque. The essence of banking business is the function of accepting deposits from public with the facility of withdrawal of money by cheque. In other words, the combination of the functions of acceptance of public deposits and withdrawal of the money by cheques by any institution cannot be performed without the approval of Reserve Bank.
The SBI group and the nationalised bank group is together categorised as Public Sector Bank.

vii) Private Bank Group

The list of the private banks is known as private group. It comprises of

A. Old Private Sector Banks

- Bharat Overseas Bank Ltd.
- City Union Bank Ltd.
- Development Credit Bank Ltd.
- ING Vysya Bank Ltd.
- The Karnataka Bank Ltd.
- Lord Krishna Bank Ltd.
- Nainital Bank Ltd.
- SBI Commercial and International Bank Ltd.
- Tamilnad Mercantile Bank Ltd.
- The Bank of Rajasthan
- The Catholic Syrian Bank Ltd.
- The Dhanalakshmi Bank Ltd.
FIGURE 1
STRUCTURE OF INDIAN SCHEDULED COMMERCIAL BANKS AS ON END MARCH 2005

INDIAN SCHEDULED COMMERCIAL BANKS

- Private Sector Banks (29)
- Old Private Bank Group (21)
- State Bank Group (8)
- State Bank of India (1)
- State Bank Associates (7)
- Nationalised Bank Group (19)
- Public Sector Banks (27)
- New Private Bank Group (8)
The Federal Bank Ltd.
The Ganesh Bank of Kurundwad Ltd.
The Jammu & Kashmir Bank Ltd.
The Karur Vysya Bank Ltd.
The Lakshmi Vilas Bank Ltd.
The Ratnakar Bank Ltd.
The Sangli Bank Ltd.
The South Indian Bank Ltd.
The United Western Bank Ltd.

B. New Private Sector Banks

- Bank of Punjab Ltd.
- Centurion Bank Ltd.
- HDFC Bank Ltd.
- ICICI Bank Ltd.
- Indusind Bank Ltd.
- Kotak Mahindra Bank Ltd.
- UTI Bank Ltd.
- YES BANK

viii) Profitability Management

The Profitability Management (PM) concept is defined as planning, measurement and control and interpretation of the profitability of organizations, services and account relationships, using transfer charging as a key-tool for calculating profitability.

ix) Non-Performing Asset (NPA)

NPA are basically the loans of banks which have no scope of being repaid. Indian commercial banks provide the following types of Credit. Loans
given to sick companies loans given to priority sectors and social welfare Loans given to companies struggling to cover their losses.

x) Profitability

The word profitability is composed of two words 'profit' and 'ability'. 'Ability' refers to the earning capacity or power of an enterprise to earn the profit. So, profitability may be defined as the ability of a given investment to earn a return from its use. Profitability of a concern indicates the financial stability and greater the possibility of profit earning, the easier it is to attract capital investment. The height of profitability depends on the ability of the management to deal intelligently and effectively to tide over risks and uncertainties through shifting them or hedging benefits. Profitability of different concerns varies as depends upon type of business, risk involved, policy decision, etc.

1.9 METHODOLOGY

Profitability is the most important and reliable indicator as it gives a broad identification of the capability of a bank to increase its earnings and it is measured by a number of factors.

The analytical frame work of the study is based on descriptive nature. The collected data were pooled together group-wise for analysis with the help of the following techniques.

I. Efficiency Analysis

The level of efficiency of commercial banks has been studied in context to branches and employees. The branches and employees are the two important wheels on which the whole banking industry is moving. Considering
the significance and contribution it appears to be appropriate to calculate the efficiency of the banks in terms of branches and employees.

a) Branch based Efficiency Analysis

The important indicators selected to measure the efficiency of the Scheduled Commercial Banks in India with regard to branches are:


b) Employee based Efficiency Analysis

The important indicators selected to measure the efficiency of the Scheduled Commercial Banks in India with regard to employee are:


c) Concentration Indices

Indian Banking System has historically evolved under the impetus of social, institutional and economic forces uniform to different banks. The efficiency of the Indian Banking System depends on the relative operational efficiency of each unit of Banking System.
To assess the relative performance Herfindhal's* index of concentration has been computed for the indicators like:

<table>
<thead>
<tr>
<th>Branch Based Analysis</th>
<th>Employee Based Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Selected Variables</strong> (Common for both)</td>
<td></td>
</tr>
</tbody>
</table>

- Deposits
- Advance
- Net Profit
- Spread
- Establishment Expenses
- Total Income
- Working Fund
- Total Expense
- Business
- Burden

The minimum value of the index would be the $\frac{1}{n}$ when there is no concentration i.e., all participating units obtain equal shares i.e., one participating unit obtains the entire share and share of remaining units is zero. Value of overall index is the sum total of all index value of the participating units and is positively associated with the degree of concentration. The lower value of overall index implies the almost similar degree of efficiency enjoyed by the majority of participating units while the higher value of overall index implies the higher degree of efficiency enjoyed by the participating units.

d) Empirical Analysis of Efficiency

The analysis with regard to efficiency has been undertaken by dividing the study period of ten years into two distinct phases. The first phase will be the initial five years of study and the second phase will be last five years.

The efficiency has been analysed with $M_1$ and $M_2$ where $M_1$ (pay-out per employee ratio) and $M_2$ (Volume of business per employee ratio)

\[
M_1 = \frac{\text{Total Establishment Expenses}}{\text{Total Number of Employees}}
\]

\[
M_2 = \frac{\text{Volume of Business}}{\text{Total Number of Employees}}
\]

II. Profitability Analysis

The Profitability Analysis is defined as planning, measurement and control and interpretation of the profitability of organizations, services and account relationships. Using transfer charging as a key-tool for calculating profitability. It is a process of exploding financial objectives into operating targets, measuring and controlling results and interpreting them.

To assess the profitability among SBI group, nationalised bank group and private bank groups of Indian scheduled commercial bank, ratio analysis, correlation, regression, analysis of variance, factor analysis has been used in the present study.

a) Ratio Analysis

Ratio Analysis is one of the most widely used techniques of financial analysis of banks. It aims at making use of quantitative information for
decision making and thus provides great help to the management in the planning and control of their activities. It enables the management to identify the causes of the changes in the profitability over the period of time and thus helps in pinpointing the direction of action required for altering the profitability prospects of the banks in future.

Ratio Analysis is used to substantiate the profitability and to identify the causes of changes. It is an important technique of analyzing the profitability of commercial organization including commercial banks.

To study the Profitability trend in Scheduled Commercial Bank in India, the indicators taken and it is measured in terms of profitability with regard to three sets of ratios.

i. Spread Ratio

ii. Burden Ratio

iii. Profitability Ratio

i) Spread Ratios

Spread plays an all important role in determining the profitability of banks. The surplus of interest earned over interest paid or simply difference between interest earned and interest paid constitutes the 'spread'. Spread along with non-interest income earned as commission, service charges, etc. forms the revenue pool out of which man power and other expenses are met. The performance vis-a-vis profitability of banks are usually related to the net earning. Hence, it is the amount of this spread and its components, i.e., interest earned and interest paid, in relation to the total working funds that is significant for the banks to analyse their profitability. The three spread ratios are as under:

(a) Interest earned as percentage of working fund.
(b) Interest paid as percentage of working fund.
(c) Spread as percentage of working fund.

ii) Burden Ratios

Burden represents non-interest expenditure of commercial banks. Expressed otherwise, it is the combination of man-power expenditure and other expenses of banks minus other incomes. Burden which is met out of spread influences considerably the profit of the bank. Higher the burden of a commercial bank, lower the profitability. Hence, proper management of burden is highly essential if a bank wants to enhance its profit. Burden ratios employed for the present study to determine the profitability of commercial banks are:

(a) Non-interest expenditure as percentage of working fund.
(b) Non-interest or other income as percentage of working fund.
(c) Burden as percentage of working fund.

iii) Profitability Ratio

Profitability ratio is the common ratio required to judge the performance of commercial banks because absolute profits improves the profitability. The analysis of profitability ratio is not only highly important to the management to measure the efficiency of the bank but it is required by different interested parties like share-holders, creditors, etc. to know the return, growth, repayment capacity, etc. Profitability ratio thus, is quite important. The following profitability ratios have been employed in the present study:

(a) Net Profit as percentage to Working Fund
(b) Net Profit as percentage to Total Income
(c) Net Profit as percentage to Total Deposit
b) Empirical Analysis of Profitability

The profitability of scheduled commercial banks in India has been analysed with the following factors. (Y represents dependent variable and X represents independent variable).

\[ Y_i = \text{Net profit as percentage to Working Fund} \]
\[ X_1 = \text{Net Non Performing Assets as percentage to Advance} \]
\[ X_2 = \text{Rural Branches as percentage to Total Branches} \]
\[ X_3 = \text{Priority Sector Advance as percentage to Total Advance} \]
\[ X_4 = \text{Credit Deposit Ratio} \]
\[ X_5 = \text{Investment to Deposit Ratio} \]
\[ X_6 = \text{Saving Deposit as percentage to Total Deposit} \]
\[ X_7 = \text{Current Deposit as percentage to Total Deposit} \]
\[ X_8 = \text{Fixed Deposit as percentage to Total Deposit} \]
\[ X_9 = \text{Interest Income as percentage to Working Fund} \]
\[ X_{10} = \text{Non-Interest Income as percentage to Working Fund} \]
\[ X_{11} = \text{Interest Expended as percentage to Working Fund} \]
\[ X_{12} = \text{Non Interest Expense as percentage to Working Fund} \]
\[ X_{13} = \text{Establishment Expense as percentage to Total Expense} \]
\[ X_{14} = \text{Provision and Contingencies as percentage to Working Fund} \]
i) Correlation Analysis

Correlation Analysis studies the relationship that exists between variables. The correlation co-efficient of the selected independent variables with the bank profitability has been worked out in order to identify the most important variables or the variable which have higher association with the dependent variable. The test of significance has also been applied in order to identify the variables which have significant correlation.

ii) Regression Analysis

Regression Analysis attempts to study the functional relationship between the variables and provides a mechanism for prediction. As profitability of banks is the result of several variables, the impact of each selected variable on bank profitability has been studied.

iii) Analysis of Variance

When the numerical measurements across the groups are continuous and certain assumptions are met, a methodology known as analysis of variance (ANOVA) is used to compare the mean of the groups.

iv) Factor Analysis

Factor Analysis technique is an appropriate technique for the studies of developmental variables. It deals directly with correlative dependence by arranging variables into independent linear combinations and permits any indicator to be tested as a dependent variable of a small set of underlying or common components.
In factor analysis, factors are formed in such a way that i) those variables that are more clearly inter-correlated are combined with a single factor. ii) the variables allocated to given factor are those that are most nearly independent of the variables allocated to the other factors. iii) the factors are derived in a manner that maximizes the percentage of the total variants attributable to each successive factor and iv) the factors are independent.

v) Discriminant Analysis

The technique of factor analysis brings out important factors associated with the selected indicators, but they represent a group of indicators taken simultaneously and hence, some of the indicators may get relatively higher importance in the two or more than two factors so derived. Therefore, it is important to look for the relative contribution of each variable in explaining the differences between the mean profitability of two periods. For this purpose, the technique of discriminant analysis has been applied.

III. Growth Analysis

The study attempts to assess the growth of banks through selective parameters.

The parameters considered for growth analysis are

- Net Profit
- Interest Income
- Interest Expended
- Spread
- Non Interest Expense
- Non Interest Income
- Burden
a) Trend Analysis

Trend Analysis evaluates the overall profitability performance of Scheduled Commercial Banks in India. It clearly indicates the magnitude, the direction of operations over a period of time. It helps to identify certain banks in respect of their level of efficiency in operation. It provides clues for developing certain feasible measures to attain reasonable growth, and highlights the trend pattern to identify the historical developments. The study attempts to assess growth of banks through trend analysis with the help of ten parameters mentioned above.

b) Exponential Growth Rate

The performance of Scheduled Commercial Banks normally grow from year to year enables it to have an enlarged base to compound the growth rate. Therefore, exponential growth function is taken to analyse the trends through selective parameters indicated above.

1.10 HYPOTHESES OF THE STUDY

The study broadly aims at examining the following hypothesis with the available data and techniques.

(i) There is no significant difference in the mean performance of net-profit to working fund among different groups of banks.

(ii) There is no significant difference in the mean performance of net-non performing assets to Advance among different groups of banks.
(iii) There is no significant difference in the mean performance of rural branches to total branches among different groups of banks.

(iv) There is no significant difference in the means performance of priority sector advance to total advance among different groups of banks.

(v) There is no significant difference in the mean performance of Credit Deposit Ratio among different groups of banks.

1.11 LIMITATIONS OF THE STUDY

1. There has been a lot of window-dressing in presenting final accounts by the commercial banks to hide the actual position. The data relating to deposits and advances, with respect to banks, shoot up at the end of the accounting year because of unscrupulous practices followed by branch manager.

2. Proper significance tests could not be made to generalize the findings of the study for the entire banking industry i.e., Foreign Banks, Co-operative banks, etc.

3. The study concentrates only on the analysis of quantitative financial data. The emerging trends in qualitative aspects of banking as customer service, job satisfaction, reduction in inequalities and regional disparities and morale of the bank employees and the general public etc. have not been taken into consideration.

4. The available data found to be unsuitable to analyse with the help of the tool instability index which has been avoided in the process of analysis.
1.12 CHAPTER SCHEME

The following chapter scheme has been adopted by the researcher.

1. The first chapter comprises of introduction, statement of the problem, review of literature, objectives of the study, period of study, scope of the study, sample design, concepts and definitions, methodology, hypotheses of the study, limitations of the study and chapter scheme.

2. The second chapter presents the determinants of efficiency, profitability and growth of commercial banks in India.

3. The third chapter assesses the efficiency performance of scheduled commercial bank in India.

4. The fourth chapter is devoted to assess the financial parameters which affect the profitability of scheduled commercial banks in India.

5. The fifth chapter portrays the growth of scheduled commercial banks on selected variables.

6. The sixth chapter narrates the summary of findings and offer suggestions for improving the efficiency, profitability and growth of scheduled commercial banks in India.
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